

**PARTNERSHIP TAXATION RECENT DEVELOPMENTS  
PENDLETON, OREGON  
DECEMBER 18, 2009**

**AICPA ISSUES REVISIONS TO SSTSS EFFECTIVE JANUARY 1, 2010**

**SECTION: AICPA**

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**CITATION: STATEMENTS ON STANDARDS FOR TAX SERVICES,  
NOVEMBER 2009**

The AICPA Tax Executive Committee issued revisions to the Statements on Standards for Tax Services effective on January 1, 2010. These standards govern the conduct of CPAs when performing tax services and are considered enforceable standards under Rule 202 of the Code of Professional Conduct. The new standards revise and replace the prior standards.

Changes include combining what used to be standards 6 and 7 into the new SSTS No. 7 and renumbering No. 8 to the new No. 7. Some of the more significant substantive changes include revising the standards for a tax return position found in SSTS No. 1. Under the new SSTS No. 1 a CPA must comply with the more restrictive of the reporting standards under the rules of the taxing agency with jurisdiction over the item or the minimum AICPA standard.

The AICPA minimum standard requires that a CPA determine a position has a realistic possibility of success (that is, a 1 in 3 chance of success on its merits) positions without additional disclosure or that a disclosed position has a reasonable basis under the law. However, federal law generally imposes the “substantial authority” standard for return positions without disclosure, so CPAs will have to meet that higher standard for federal filings.

SSTS No. 7 (formerly SSTS No. 8) also had notable changes, adding that when written advice is provided it should comply with the standards of any applicable taxing agency in addition to the AICPA standard, a member should consider tax return reporting, disclosure and potential penalty issues when giving advice and adds to the list of factors to be considered when advice is given.

## **BASIS CALCULATION IS A CUMULATIVE AND NOT YEAR BY YEAR CALCULATION WHEN APPLYING "NOT BELOW ZERO" LIMIT FOUND IN §705(B)**

SECTION: 705

CITATION: *LEBLANC V. UNITED STATES*, COURT OF FEDERAL CLAIMS, 1:05-CV-00743, 12/4/09

What does IRC §705(b) mean when it says, in computing partnership basis, that the amount will not go below zero? The taxpayer in this case claimed that it means that a taxpayer's basis gets reset to zero at that point, and any losses passed out in excess of that amount will never apply in computing basis. That was important because, in the taxpayer's case, the partnership later passed out amounts of income prior to the taxpayer's eventual abandonment of their interest, and they claimed a loss based on a calculation that added in that later income while ignoring a large first year loss that was in excess of their basis at the time.

The IRS disagreed, arguing that basis is a cumulative calculation as envisioned by §705, and the §705(b) stopping basis at zero only served as a temporary "hold" at that point until the cumulative calculation brought the basis above zero. If the IRS's position was correct, the taxpayer's basis in the activity would have been zero at the date of abandonment, and thus there would be no loss to deduct.

The Court of Claims agreed with the IRS's view, noting that if the taxpayers were correct, wildly different results would be obtained had that loss year been the final rather than first year of the partnership.

## **TRANSFER OF ASSETS TO PARTNERSHIP FOLLOWED BY PLEDGE OF INTEREST TO RECEIVE NONRECOURSE LOAN AND RELATED PUT HELD TO BE DISGUISED SALE**

SECTION: 707

CITATION: UNITED STATES V. G-I HOLDINGS INC., 12/14/09

The disguised sale rule of §707(a)(2)(B) was applied in a case where a taxpayer contributed assets from a division of its business worth \$480 million dollars to a trust, and then shortly thereafter the interests were transferred to a trust that received a \$460 million nonrecourse loan against those interests, of which \$450 million was transferred to the taxpayer. A put agreement required the partnership to purchase the partnership interests of the taxpayer at the taxpayer's capital account at the time the put was exercised.

The taxpayer contended that these transactions were truly separate, and that they could not be collapsed under §707(a)(2)(B). However, the U.S. District Court of New Jersey disagreed. When it analyzed the entirety of the transaction it found that the transaction has been structured in an attempt to avoid tax on the sale of the division by creating the partnership, but then effectively disposing of that interest indirectly through the nonrecourse loan borrowing procedure.

The Court found that the taxpayer had no reasonable expectation of a profit on the underlying transaction in excess of the costs it had incurred, that its potential losses had been capped in the transaction and that the capital contribution and loan were a "package deal" that had to be looked at as whole. Thus the Court concluded that the \$450 million part of the package was a disguised sale.

However the victory proved a hollow one for the IRS. The Court found that the IRS had not assessed the tax due within the three year statute of limitations period and the transaction did not cause an omission of income from the return in excess of 25% that was necessary to trigger the six year statute of limitations under §6501(e). So while the taxpayer should have paid tax on the transaction, the IRS waited too long to raise the issue.

## PAYMENTS TO RETIRING PARTNER WERE ORDINARY INCOME DESPITE MISREPORTING BY PARTNERSHIP

SECTION: 736

CITATION: WALLIS V. COMMISSIONER, TC MEMO 2009-243, 10/27/09

A retiring partner received a set of payments from his law firm, of which \$32,721 was payment for the partner's capital account and \$80,000 was for "Schedule C" benefits. Schedule C referred to the partnership agreement, which provided for Class C interests for partners that had a nonownership interest and for which capital contributions were not made. The partnership agreement provided that a retiring partner would be paid for his Schedule C interests upon attaining age 68.

The partner in question owned other interests for which there were capital contributions, but had also been awarded Schedule C interests over the years. However, he reported nothing on his returns for either the payment related to his capital account or the payment for the Schedule C units. As well, his old partnership issued a Form 1099MISC reporting the \$80,000 payment for Schedule C benefits as nonemployee compensation. At trial the taxpayer conceded he should have reported the proceeds, but took the position that he had sufficient basis to absorb the payment for the capital account received in that year and that the Schedule C benefit payments should be capital gain.

The Court found the payments to the partner for his capital account related to the other interests did not give rise to income, as the IRS failed to show that the payments were in excess of the partner's basis. Given that finding, there was no adjustment related to the failure to report the amount of proceeds received for the capital account.

However, the Court found the Schedule C payments were §736(a) payment, being ordinary income to the taxpayer and not capital gain. The Court also had no sympathy for the taxpayer's argument that he had failed to report the \$80,000 as income because he could not do so properly (as guaranteed payments from the partnership) and also agree with the partnership's reporting (as nonemployee compensation). The Court imposed penalties on this position.

**SON-OF-BOSS TRANSACTION FOUND TO LACK ECONOMIC SUBSTANCE, SO ISSUE OF RETROACTIVE APPLICATION OF REG. §1.752-6 NOT RELEVANT.**

SECTION: 752

CITATION: PALM CANYON X INVESTMENTS V. COMMISSIONER, TC MEMO 2009-288, 12/15/09

The Tax Court dodged the question of whether Reg. §1.752-6 can be applied retroactively to unwind a Son-of-BOSS style transaction, instead ruling that the underlying transaction lacked economic substance. The court applied both the subjective and objective prong of the economic substance test. It found that the transaction failed the subjective prong, as the nontax reasons offered for executing the transaction were not credible. Among the reasons the court ruled that way included a finding that there was no real need for the taxpayers to hedge foreign currency in the foreseeable future (one of the purported reasons for entering into the transaction), no investigation into the foreign currency aspects of the transaction, a lack of rational economic behavior in pricing the contracts, the adding of a partner solely to be able to remove that partner to trigger the basis shift in liquidation of the partnership, and that the transaction was specifically developed as a tax shelter.

The transaction also failed the objective test, which requires showing the transaction had a reasonable prospect of earning a profit. The court found that the prospects of the transaction hitting the “sweet spot” where it would turn profitable were small (estimated at 1.3% by an individual involved). And, in any event, the fees paid were greater than any potential profit the transaction might produce.

The Court also found that since it held the case was appealable to the Court of Appeals for the District of Columbia, that the transaction was subject to a penalty under §6662 for a valuation misstatement. While the Fifth and Ninth Circuits had held that the valuation negligence penalty could not apply when a transaction was disregarded for economic substance, the Tax Court disagrees with that holding. While both parties originally stated the case was appealable to the Ninth Circuit, the IRS later disagreed and the Tax Court agreed with the IRS’s new view. The Court also denied relief from any other penalties under §6662.

## **TRANSFER TO FAMILY LIMITED PARTNERSHIP WAS BONA FIDE SALE, AND THUS VALUE OF STOCK NOT INCLUDABLE IN TRANSFEROR'S ESTATE**

SECTION: 2036

CITATION: ESTATE OF BLACK V. COMMISSIONER, 133 TC NO. 15, 12/14/09

The Tax Court ruled that a transfer to a family limited partnership of a taxpayer's interests in stock in a company he held a significant interest in, at the same time transfers by his son and two trusts for his grandchildren to the same partnership, was a bona fide sale for full and adequate consideration, and thus not subject to being yanked back into the transferor's estate under §2036(a). The Tax Court applied the standard of the Third Circuit Court of Appeals, to which the case would be appealed, that the sale must be a good faith transfer that offers the transferor some benefit outside the transfer tax context.

The Court found that Mr. Black had a legitimate concern that shares of stock in the closely held company might be disposed of either by his grandchildren when their trusts terminated, or by his son due to feared (and eventually actual) divorce.

However, the estate of the decedent's spouse was denied a deduction for interest on a loan received from the partnership to enable her estate to pay its estate. The Tax Court that because, under the facts of the case, the only realistic way that loan could have been repaid per its terms would have been to have redeemed a portion of that estate's interest in the partnership, an action that would have served to create the same necessary liquidity had it been undertaken on the day the loan was made. The loan was deemed unnecessary, as the only effect of the loan as compared to a redemption was the creation of a deduction of \$20 million for interest on the purported loan, playing off the fact that estate tax rates (which would create the benefit from the deduction) were higher than income tax rates.

## FRESH FROM AFFIRMATION IN CHRISTIANSEN, TAX COURT RULES USE OF FORMULA CLAUSE FOR GIFT SPLIT BETWEEN CHARITIES AND OTHERS DID NOT VIOLATE PUBLIC POLICY

SECTION: 2503

CITATION: ESTATE OF PETTER V. COMMISSIONER, TC MEMO 2009-280, 12/7/09

Within a month of the Eighth Circuit affirming its holding in Christiansen that formula clauses in estate planning documents do not violate public policy, the Tax Court ruled again that a formula clause in a gift split between a charity and others that served to insure that any subsequent adjustment to the value of the assets transferred would not generate a gift tax was not a violation of public policy. The Court upheld the validity of the clause, as well as a full deduction for the value of the interests eventually treated as going to the charity as of the date of the gift for income tax purposes.

The formula clause provided that, effectively, the charities would receive the portion of the donated interests in the family LLC that would be in excess of what could pass gift tax free to the other donees. When the original value was challenged on exam, the amount that would go to charity was increased, something the IRS argued frustrated public policy giving no incentive to properly value the assets.

The Tax Court disagreed, noting in this case that the charities had an obligation, if they wished to maintain their tax exempt status, not to act “in cahoots with a tax-dodging donor.” As well, the state’s attorney general is given the right under state law with enforcing the charity’s rights—so there were checks in place to prevent abuse, so that the threat of a gift tax was not needed to insure the items were properly valued.

## **EIGHTH CIRCUIT RULES A FRACTIONAL DISCLAIMER DOES NOT VIOLATE PUBLIC POLICY**

SECTION: 2518

CITATION: ESTATE OF CHRISTIANSEN, CA8, NO. 08-3844, 11/13/09

The Eighth Circuit held in the Estate of Christiansen that a fractional disclaimer of an inheritance above a set amount did not violate public policy, and allowed the recalculation of the amount of the disclaimer, also holding that the IRS examination was not an “act or precedent event” that would trigger Reg. §20.2055-2(b)(1). On the public policy issue, the Eighth Circuit held that merely because such a fractional disclaimer would create a situation where the IRS would not be able to collect any additional tax if it challenged the value of the asset, that did not violate any public policy.

The Court noted that the IRS was charged with enforcing the tax laws, and not with collecting the maximum amount of tax. The Court found no indication that Congress had, as a matter of policy, wanted to give the IRS the incentive to collect the maximum tax and thus a fractional disclaimer that would have the effect of eliminating any possible tax did not violate any public policy. The Court also pointed out that, in this particular case, due to other issues that 25% of the increase in value would create a tax liability.

The Eighth Circuit’s willingness to address and reject the public policy argument is a matter of interest, since such fractional formulas that serve to insure that any change in value simply increases the transfer to a entity for which a full deduction would be allowed is a technique that is sometimes used in estate planning documents.

## **IRS ADDS NEW INQUIRIES AND NEW SCHEDULE B-1 TO 2009 FORM 1065**

SECTION: 6031

CITATION: 2009 FORM 1065, 12/15/09

The Form 1065 for 2009, while not being as radical a change as the one we saw when going to the 2008 1065 from the 2007 version, still has some new additions that indicate areas of IRS interest for partnerships. The changes for 2009 include:

Schedule B-1. A new Schedule B-1 has been added which will be required to be filled out when the partnership checks yes to questions 3a or 3b on Part B, indicating there is a greater than 50% partner.

§704(c) Issues. The partners' K-1 now contains an item "M" that asks if a partner contributed assets that had a built-in gain or loss. If the question is answered yes, a statement must be attached that describes each property the partner contributed, the date it was contributed and the amount of the built-in gain or loss.

§108(i) Elections. A new code has been added to the K-1 to report information related to any election the partnership makes under §108(i), added by the American Recovery and Reinvestment Act of 2009, to defer recognition of gain on the cancellation of certain debts that occur after 2008 but before 2011.

## **TAXPAYER ALLOWED TO INTRODUCE EVIDENCE FOR TIMELY MAILING FOR ILLEGIBLE USPS POSTMARK**

SECTION: 6213

CITATION: [MADDOX V. COMMISSIONER, TC MEMO 2009-241, 10/26/09](#)

The taxpayer filed a Tax Court petition regarding deficiencies for 2005-2007. The taxpayers' attorney signed the petition, dated December 17, 2008. The attorney claims to have mailed it by placing it in the mailroom in his office before 4:00 pm on Friday, January 2, 2009. January 5, 2009 was the last day for timely filing, which was the following Monday.

The petition did not arrive at the Tax Court until January 23 and the postmark was illegible. The IRS claimed that the late receipt, combined with the illegible postmark, meant that the petition was not timely filed. The Court, however, noted that if the postmark is illegible (so that we can't tell if it is dated before or after the appropriate date) the taxpayer can introduce other evidence to show what that date should be. The Court accepted the testimony of the taxpayer's attorney.

It is important to note that if the postmark had been legible but dated after January 5, the petition would not have been timely. It appears likely that the document got "hung up" somewhere after the attorney put it in the mail basket until it reached the Tax Court. Had that hang up been before the postmark had been applied, a legible postmark may have been fatal to the timely filing. There is a reason why getting a certified mail receipt stamped by a USPS employee (which serves as proof of the postmark date) is the preferred way to file documents with the taxing authorities.

## **IRS, AFTER LOSING IN COURT, REVISES REGULATIONS TO REDEFINE AN OVERSTATEMENT OF BASIS AS CREATING AN UNDERSTATEMENT OF INCOME UNDER §6501(E)(1)(A)**

SECTION: 6501

CITATION: TD 9466, TEMP. REG. §301.6501(E)-1T, 9/28/09

Smarting from losses in the case of Bakersfield Energy Partners (568 F.3d 767, CA9) and Salman Ranch Ltd. (573 F.3d 1362, CA FC), the IRS has issued temporary regulations holding that an overstatement of basis for assets sold will count in determining if there has been an understatement of gross income for purposes of applying the 25% omission of income test under IRC §6501 that triggers a six year statute of limitations on assessment. In both of the above cases the courts ruled that the item of gross income to be tested was the sales price reported and not the net gain/loss reported when looking to trigger the six year statute. Both courts determined that Congress's key issue was insuring the IRS was put on notice about the transaction, which reporting the sale did.

However the IRS is not happy with that decision, being aware that quite often the item is reported as a single line item on a K-1 from a passthrough entity. The IRS indicates that under the "adequate disclosure" exception a taxpayer who adequately discloses the nature and amount of the omissions from gross income will not be subject to the six year statute.

The IRS is attempting an end run around the contrary decisions by changing the temporary regulations to clearly state that overstatements of basis amount to an understatement of income, noting that both courts had commented that the previous temporary regulations were ambiguous. The IRS position is that these new regulations apply to all cases where the period of time for assessing tax had not expired by the time the regulations were issued.

## **INTEREST DUE ON REQUESTS FOR REPAYMENTS OF AMOUNTS THAT REPRESENT EXCESS §6603 DEPOSITS EXPLAINED**

SECTION: 6603

CITATION: CHIEF COUNSEL NOTICE CC-2010-002, 12/2/09

Taxpayers that end up asking for a refund of the amount of a payment made as a deposit in a tax dispute that turns out to be in excess of the tax actually due may be eligible for interest on that amount, but not based on the standard overpayment interest rules. The Chief Counsel's office explains that if a taxpayer submits an amount no greater than the maximum amount the taxpayer reasonably expects could be due for the items in dispute, interest would be paid under the rules of §6603 rather than the general rules for overpayments under §6611. Such an excess arose from a "disputable tax" as defined by §6603(d)(2)(A).

However, if the taxpayer puts on deposit an amount in excess of the amount that might reasonably be expected to be the maximum tax due on the disputed amounts, no interest is due on any amount that is in excess of that maximum when it is later refunded.

## **PENALTIES INCREASED DRAMATICALLY FOR LATE FILED PARTNERSHIP OR S CORPORATION RETURNS**

SECTION: 6698 & 6699

CITATION: WORKER, HOMEOWNER, AND BUSINESS ASSISTANCE ACT OF 2009, SEC. 16, 11/6/09

Congress has revisited what has become a recent favorite place to visit to find funds—raising the penalties imposed on late filed partnership and S corporation returns. The penalties for late filed returns for taxable years beginning after December 31, 2009 will be \$195 per partner/shareholder per month or portion of a month. The penalty continues for up to 12 months. This is an increase from the current level of \$89 per month.

## **IRS SUSPENDS ENFORCEMENT OF §6707A PENALTIES PENDING CONGRESSIONAL ACTION TO REVISE PENALTY**

SECTION: 6707A

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CITATION: LETTER FROM IRS COMMISSIONER, 9/24/09

The IRS Commissioner, in a published letter, has agreed to suspend the imposition of penalties for failure to disclose properly a taxpayer's involvement in either a listed or reportable transaction where the amount of tax savings was less than the penalty prescribed by law. The IRS will suspend such action through December 31, 2009 in response to a letter from the chairs and ranking minority members of the House Ways and Means and Senate Finance Committees that indicated the Congress was concerned about the penalties required by the law were out of line with tax benefits received, and planned to make revisions to §6707A.

Preparers will need to pay attention to insure that a) the Congress actually enacts revisions to this provision and b) to understand when the revised rules will apply and what penalties will continue to apply. In this author's view, it is likely that rather than removing the penalties entirely in such cases, Congress will more likely cap the penalty at some level, perhaps tying it to the net tax benefits received from the transactions.